Jean-Claude Trichet: The current state of the EU banking sector

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Annual Congress of German Savings Banks, Frankfurt, 5 May 2004.

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Ladies and Gentlemen,

It is both a pleasure and an honour to be invited to speak here today at the Annual Congress of German Savings Banks. Being in front of such a distinguished audience of representatives of the financial community, I would like to present some views on the current state of play in the European banking sector. I will in particular analyse the factors that have contributed to its resilience over recent years.

Since 2000, EU banks have been confronted by an extraordinary combination of adverse financial market shocks against the backdrop of a slow-down in the economy. Some commentators have even been surprised by the few banking problems in the euro area during this period, given that earlier episodes of slow growth often went hand in hand with severe problems in the sector. For central banks and banking supervisors, the resilience of the EU banking sector is, of course, very good news. At the same time, it raises a number of questions. What is now so different compared with the stressful periods that banks experienced in the past and what factors have contributed to this resilience?

A turbulent period for EU banks

But before addressing these issues, let me start by briefly recalling how challenging the environment has actually been for EU banks over recent years. Without a doubt, the most momentous technical and strategic challenge was the **introduction of the single currency**, now more than five years ago. The very smooth transition that followed the adoption of the euro almost makes us forget the uncertainties, and sometimes even concerns, expressed before 1999 about the structural implications the euro might have on the euro area banking sector.

The second challenge faced by banks in recent years was that not long after the banking sector had begun to adjust to operating with a new currency - including all of the efforts that this entailed - an **exceptional series of adverse events** followed in quick succession. After an almost uninterrupted stock market boom since 1995, a severe stock market correction set in in March 2000 and investors faced three consecutive years of negative returns. Investor confidence was also badly shaken by unprecedented episodes of serious corporate malfeasance. Although most of the main abuses took place abroad, Europe also had its fair share.

Over time, we have observed that banks have increasingly diversified into securities trading, investment banking and asset management. Although much was expected from this diversification strategy, the market correction was a reminder that fee income generated by these businesses also carries risks. Looking back, I think we can also say that some banks entered the businesses too late and at too high a price. The corporate scandals that coincided with the market downturn raised further questions about certain bank practices and Chinese walls did not always prove to be as impermeable as might have been expected.

In my list of stressful events, I should also mention the re-emergence of **country risk problems** and the fall-out from the **terrorist attacks** in the United States. Country risk re-emerged as Turkey and Argentina were caught up in currency and banking crises. Although the crises had only limited economic effects on the EU banking sector as a whole, some banks incurred substantial losses. As to the tragic events in the United States, they had an immediate effect on the working of financial infrastructures and markets, but this was tackled quickly and efficiently by the competent authorities, including those here in Europe. In the medium term, however, the attacks shook investor and consumer confidence further.

The third challenge, to conclude my brief overview, is that this extraordinary set of events took place at the same time that the **economy was starting to slow down** from the second half of 2000 onwards. As debt ratios in the corporate sector had risen significantly through the years of the stock market boom, signs of financial distress quickly surfaced as firms found that profits were not matching earlier expectations.

Overall resilience despite isolated weaknesses

But in spite of the circumstances that I describe here, **the EU banking sector's financial health remained overall robust**. The return on equity of EU banks peaked at 12% in 2000. The sector's profitability subsequently declined for two consecutive years, reaching 8.6% in 2002. Increased loan-loss provisions for corporate loans, reduced commissions and trading income from capital market-related business were mainly behind this fall. Although the decline was substantial, overall profitability levels continued to be well above those recorded in the second half of the 1990s. In the course of 2003 profitability picked up again.

Banks' solvency levels remained relatively unaffected by the adverse events. Thanks to these adequate financial buffers, banks were able to withstand the shocks in their operating environment. The aggregated total regulatory capital ratio continued to hover around 12% throughout the period after 2000, which is well above the required minimum ratio of 8% for individual institutions.

Although the overall picture was rather comforting, I have to qualify this somewhat by saying that some individual institutions indeed experienced serious difficulties. Often this was because of problem loans in certain sectors, such as real estate, or because of the disappointing results in market-based activities. In some instances, the intervention of public authorities or private banks was required to prevent banks from failing.

Possible reasons for the EU banking sector's resilience

Ladies and gentlemen, I now come to the essence of my question, namely the factors that have accounted for the EU banking sector's resilience over recent years. I am of the opinion that the benign combination of cyclical and structural factors contributed to this resilience.

Let me start with the **cyclical factors**. Although the economy started to slow down in 2000, it was preceded by a period of booming financial markets and strong growth. This expansive period helped banks to build up financial buffers sufficient to withstand the subsequent downturn. Although the economic conditions were weak for a long period of time, the slowdown itself was relatively mild.

Macro-economic instability, which so often coincides with a banking crisis, was absent in the EU in the period from 2000 onwards. It is my conviction that the **economic and monetary union** contributed significantly to this benign environment. First, by abolishing exchange rates between the former euro area currencies, exchange rate turbulence was avoided. Second, the adoption of a common policy framework based on price stability, fiscal discipline and the implementation of structural reforms contributed favourably. The low inflation and interest rate environment, as well as sustained real estate prices, supported some lines of banks' business. The retail business fared well and mortgage lending was dynamic in the face of declining financing costs and increasing house values. This helped to counteract weakened corporate lending and the market-related activities of banks.

I now come to the **structural factors** that contribute to the EU banking sector's resilience. There I see that **efforts made both by authorities and by banks**, as well as developments in financial markets, have paid off. As a central banker, I would like to start with the role played by the authorities. Over recent years, the **regulatory and supervisory framework** for banks has been greatly reinforced. Here we should duly recognise the progress made under the influence of the extensive guidance developed by the Basel Committee on Banking Supervision. At the EU level there have also been great achievements and crucial building blocks of a common sound regulatory regime have been agreed upon. Here I am referring to the rules on access to the banking business, capital requirements, large exposures and group-wide supervision.

Another positive development I see is the **extensive international cooperation and information exchange between authorities**, who, as a result, are able to address the challenges of a banking business that is increasingly performed across borders. In this context I have to stress the valuable work that is being undertaken by the ESCB's Banking Supervision Committee. The committee, which consists of EU national central banks and banking supervisors, performs extensive work in the area of financial stability monitoring. It does this by looking both at cyclical and structural developments that might affect the EU banking sector's resilience.

I equally want to stress the efforts made by banks. **Risk management** has been growing in importance and is becoming more integrated in banks' overall decision-making. Thanks to innovation in financial markets and advances in the quantification of risk, risk management practices have been significantly improved. Although concerns have been voiced about the spectacular growth in credit derivatives, they also allow banks to better shape their risk profile. Risk models which are increasingly being used to gauge credit and operational risk allow for an empirical underpinning of risk management. Through joint projects such as the one being undertaken by federations of savings banks to develop risk know-how and management systems, advanced risk management tools have also become available to smaller institutions. Outsourcing and centralisation in the field of individual banks' payment and settlement systems is another example of such joint projects which are being undertaken in a number of EU countries at the same time.

The profitability pressures I described earlier have not led banks into immobility; in fact they have been quite **responsive in taking corrective measures**. Lending terms have been tightened and more risk-based pricing strategies applied. In addition, non-core assets have been shed and the number of branches and employees reduced. This is particularly evident in the national banking systems that were in need of further substantial restructuring.

I want to conclude my overview by pointing to the **developments in financial markets in Europe**. Again, the single currency has been a beneficial factor. This is most clearly illustrated by the unsecured money market. A very well integrated money market supported by TARGET, the area-wide wholesale payment system, now allows liquidity to be quickly channelled from areas of the European banking sector that show surpluses to areas that suffer shortages. This has contributed to a more robust banking system. The emergence of a number of highly liquid euro-denominated exchange contracts has also facilitated banks' risk management.

Concluding remarks

Ladies and gentlemen, let me briefly conclude. I have discussed how, under the challenging conditions of the past few years, the EU banking sector has remained robust thanks to a benign combination of cyclical and structural factors.

Nevertheless, a number of challenges remain both for banks and authorities, in particular, in the structural domain. Several EU countries are still faced with excess capacity in their banking systems that will have to be further reduced over time. Likewise, cross-border consolidation might accelerate as mergers and acquisitions pick up again following improved market conditions. Regarding regulation and supervision there is the new committee structure that is currently being set up at the EU level to improve rule-making and implementation; its agenda is demanding and challenging. Other important challenges that lie ahead are the introduction of the New Capital Accord and the International Accounting Standards, whose potential structural effects on the EU banking sector are still uncertain. Finally, another significant change for the EU banking sector, as I mentioned, is the recent entry of the new Member States into the EU. However, as these countries' banking systems are, to a large extent, already integrated in the EU banking system, this should be favourable for a smooth transition.

Ladies and gentlemen, I thank you for your attention.